Scotiabank

GLOBAL ECONOMICS

SCOTIA FLASH

August 29, 2025

Contributors

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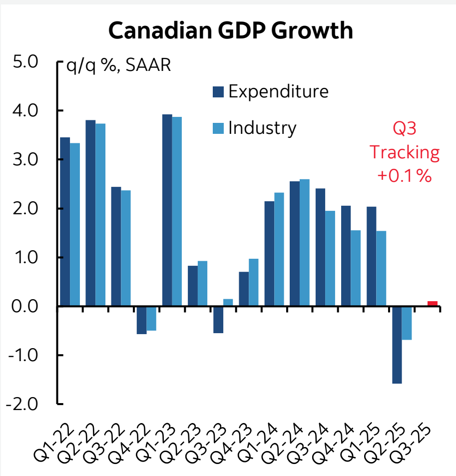
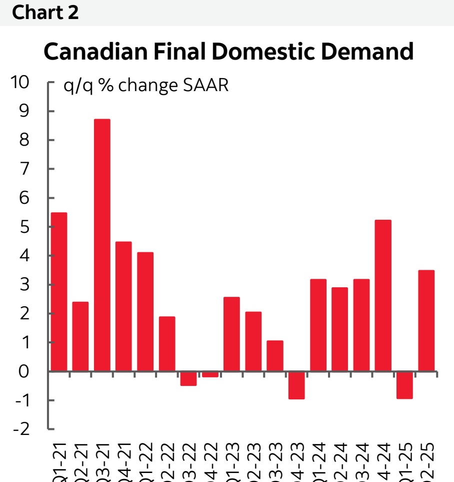
Chart 1



Sources: Scotiabank Economics, Statistics Canada.

Chart 2



Sources: Scotiabank Economics, Statistics Canada.

Canada's Domestic Economy Doesn't Need Further Rate Cuts; US Inflation Warnings

- **Canadian GDP shrank by more than expected in Q2…**
- **…but the domestic economy ripped higher…**
- **…led by rate-sensitive consumer spending and housing**
- **The BoC should be encouraged by the details, downplay headline volatility…**
- **…as easing on the back of strong final domestic demand would be a policy mistake …**
- **…but let's see jobs and CPI before deciding on September 17th…**
- **…even though the rate sensitives may only just be getting started**
- **US core inflation has accelerated over the past two months…**
- **…with services leading the way, tariffs still ahead…**
- **…sending a cautious signal to the Fed**
- **Both the BoC and Fed should have no comfort that inflation risk has been licked**
- **The US consumer is getting magattacked!**

Canada Q2 GDP, q/q SAAR %:

Actual: -1.6

Scotia: -0.3

Consensus: -0.7

Prior: +2.0 (revised from 2.2)

Canadian GDP m/m %, SA, June:

Actual: -0.1

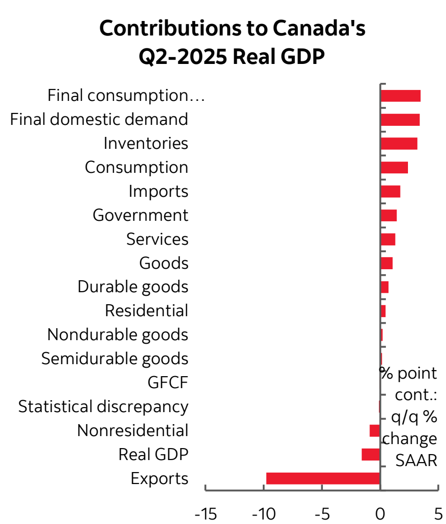
Scotia: +0.2

Consensus: +0.1

Prior: -0.1

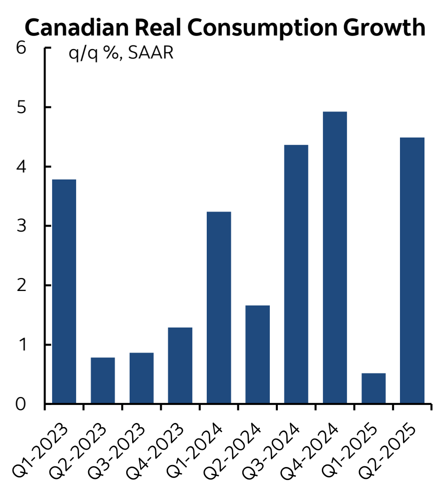
Canadian GDP m/m %, SA, July flash estimate: +0.1

Chart 3



Sources: Scotiabank Economics, Statistics Canada.

Chart 4



Sources: Scotiabank Economics, Statistics Canada.

Canada's economy was much stronger than the headline GDP reading would suggest—so much so that it's a textbook example for students of how sometimes GDP isn't a great measure and particularly from the standpoint of what policy should do about it.

Yes, GDP disappointed expectations, for starters. Q2 GDP shrank by –1.6% q/q SAAR and so hats off to the BoC's estimate in the July MPR that was closest, although that was a mountain of data ago and so luck also likely played a bit of a role alongside noisy trade and inventory swings that are hard to estimate. Chart 1 shows q/q growth using both the complete expenditure-based accounts that the BoC and other forecasters emphasize, as well as the higher frequency monthly production-based accounts. I'll come back to Q3.

And yes, the monthly GDP figures aren't great. They're not terrible either, but –0.1% m/m SA in June and +0.1% m/m in July's early estimate signals soft momentum.

But the key here lies beneath the hood. The domestic economy ripped higher in Q2.

The measure of relevance in that regard is final domestic demand which adds consumption plus investment plus government spending and hence does not include trade and inventory effects. FDD was up by a whopping 3.4% q/q SAAR in Q2 (chart 2).

Why should anyone care? For two reasons.

For one, GDP is being wildly distorted by tariff front-running and unwinding effects in trade and inventory numbers and so it's important to smooth them out over time while remaining cautious toward the path ahead. Here are the figures on these effects and chart 3 shows the weighted contributions to GDP growth in Q2:

- Exports dragged 9.8 percentage points off of GDP in Q2 at an annualized rate because they plunged by 27% q/q SAAR in Q2 after jumping by about 7% in Q4 and then 6% in Q1.
- Imports offset some of the weakness in net trade (exports minus imports) because imports fell by 5.1% q/q SAAR in Q2 which means less of an import leakage drag effect on Q2 GDP and hence they added 3.2 ppts to Q2 GDP growth. Imports had previously been surging by 2½% in Q4 and 3½% in Q1.

And the second reason one should care about Final Domestic Demand is because of what it reveals about the household sector:

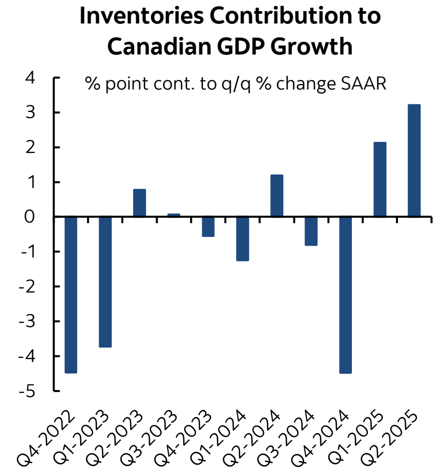
- Consumer spending was up by a whopping 4.5% at a seasonally adjusted and annualized rate (SAAR). Chart 4. That was big enough to contribute 2.4 percentage points to Q2 GDP growth in weighted terms which is huge.
- housing added 0.5 ppts to Q2 GDP growth because housing investment was up by 6.3% q/q SAAR.

The other parts of the domestic economy were more mixed than the resounding strength in the household sector.

- Inventories added 3.2 ppts to Q2 GDP growth after adding 2 ppts to Q1 GDP growth as companies stockpile before global tariffs and other drivers of inflation make them potentially more expensive. Chart 5.
- business equipment spending subtracted 1.3 ppts, structures added 0.3 ppts.
- and government spending added 1.1 ppts with government fixed investment adding another 0.4.

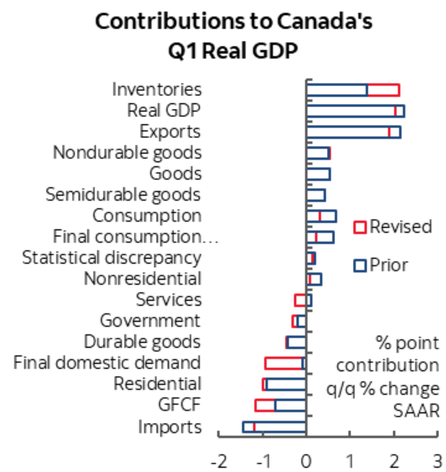
There were also revisions to Q1 GDP shown in chart 6. Inventories added more than previously estimated (2.1 ppts instead of 1.4). Imports declined more than initially

Chart 5



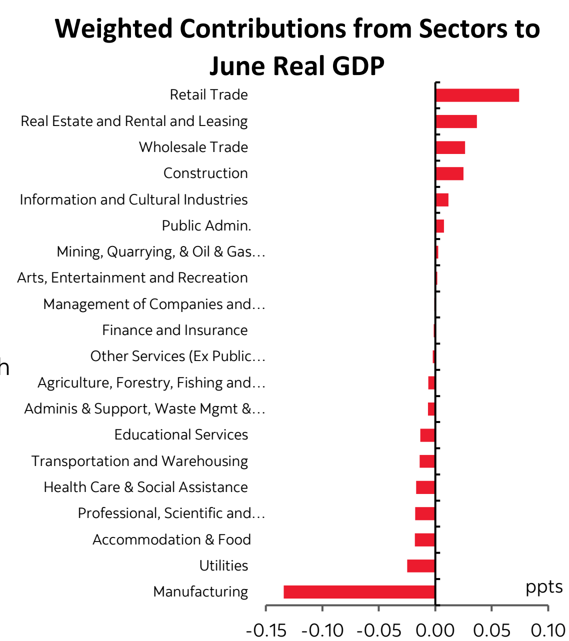
Sources: Scotiabank Economics, Statistics Canada.

Chart 6



Sources: Scotiabank Economics, Statistics Canada.

Chart 7



Sources: Scotiabank Economics, Statistics Canada.

estimated and therefore added more to GDP growth on revisions. Everything else was either left untouched or revised lower. Some of the Q2 rebound in Final Domestic Rebound was due to a downward revision to Q1, but even net of this jumping off effect from Q1 the figures for Q2 were solid.

Recent Momentum

The June and July monthly GDP figures signal softness, but no contraction on the trend.

June GDP slipped by –0.08 %m/m SA. Manufacturing was the main reason (chart 7), much of which was offset by consumer and real estate contributions.

July's advance guidance points to a +0.1% m/m SA gain. We don't get details other than this light guidance from Statcan:

> "Increases in real estate and rental and leasing, mining and quarrying (except oil and gas) and wholesale trade were partially offset by a decrease in retail trade."

This leaves us tracking essentially no growth in Q3 (+0.1% q/q SAAR) but based on highly preliminary data with a lot more still ahead including important details like whether household sector momentum is maintained.

How Will the BoC React?

The BoC should emphasize the final domestic demand detail— which they have always tended to do in their statements at times like this—and fade the headline GDP number. I still want to see next Friday's spin of the wheel for Canadian jobs (+35k is my estimate) and then the next week's CPI figures and other information, but the market may not be correctly interpreting what these numbers m ean to the BOC.

In general, the rate sensitive areas of the economy are accelerating. We see that in home sales that are up 3 months in a row, housing starts that are up 4 months in a row, retail sales that are doing fine, and auto sales that are up. And now look at the consumption and housing components of GDP that were very strong.

Obviously there are risks ahead, but they are two tailed, not all on one side. Trade uncertainty is a modest risk at this point with a minimal effective tariff shock and flexible currency with bidirectional uncertainties into the CUSMA negotiations; the biggest risk to Canadian exports is whether US growth proves to be resilient or not which puts the income pull effect on Canadian exports ahead of tariff-related price sensitivities. On the other hand, we've only just begun to see pass through of rate cuts. The first in July of last summer is only at the one-year anniversary and the last in March is still just a baby. There are 12–24 month lags for monetary policy actions and so a lot of the rate pass through to what's been done is still ahead.

US Consumers Are Getting Magattacked!

The US data was generally boring and so I'll give it short shrift.

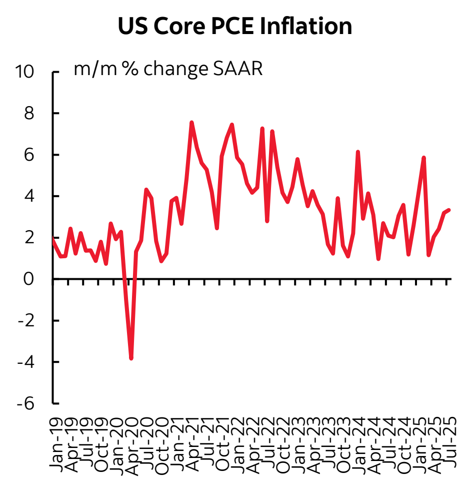
Core PCE landed on the screws at 0.27% m/m SA in July. That's the second straight month of 0.3% m/m with slight upward rounding. Chart 8.

Tariffs? Oh please. This is more about services inflation (chart 9). Tariffs come later. Inflation risk remains very much alive and kicking in the US.

The consumer is paying the price. US consumption isn't strong and headlines imo are exaggerating its strength. Consumer spending was u pby 1.6% q/q SAAR in inflation-adjusted terms in Q2, and is tracking 1.3% in Q3. These numbers follow Q1 consumption that was up by only 0.5% q/q SAAR.

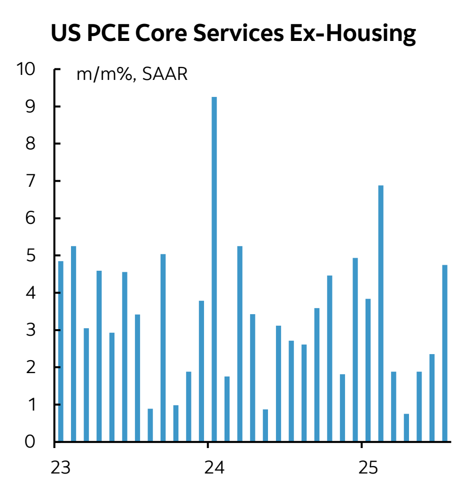
That's a U.S. consumer showing more caution. Gosh, wonder why.... The cycle may be maturing and they've been magattacked! It's entirely feasible that a combination of much higher policy uncertainty, concern about a slowing labour market and economy, and the effects of tariffs and immigration are dragging down consumption growth.

Chart 8



Sources: Scotiabank Economics, BLS.

Chart 9



Sources: Scotiabank Economics, BLS.